STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**04/09/07**	Bill No:	**SB 359**
Tax:	**Sales and Use**	Author:	**Runner and Dutton**
Related Bills:	**AB 1152 (Niello)** **AB 1206 (Smyth)** **AB 1681 (Houston)** **SB 740 (Calderon)**		

This analysis is limited to the sales and use tax provisions of this measure.

BILL SUMMARY

This bill would, among other things, do the following:

1. From January 1, 2008 until December 31, 2017, exempt from sales and use tax those gross receipts in excess of $1.88 per gallon on the sale or purchase of fuel and petroleum products to an air common carrier on a domestic flight, as specified.
2. From January 1, 2008 until January 1, 2018, exempt from sales and use tax purchases of tangible personal property, as specified, by new manufacturers and software producers, as defined.
3. For taxable years beginning on January 1, 2007, authorize income tax credits based on certain wages paid or amounts paid to purchase or lease certain property used to produce motion pictures or commercials in California, and, in lieu of claiming the motion picture credit, the bill would allow qualified taxpayers to claim either a refund of sales or use tax paid under the Sales and Use Tax Law, or a credit against a sales or use tax liability due, that is equal to the income tax credit amount allowed.

ANALYSIS

AIR COMMON CARRIERS (SECTION 6357.5)

Current Law

Under existing law, Section 6385 of the Revenue and Taxation Code provides a sales tax exemption for the sale of tangible personal property, *other than fuel and petroleum products*, sold to air, water, and rail common carriers when that property is shipped to a point outside this state under specified conditions. This section additionally provides a sales tax exemption for that portion of the sale of fuel and petroleum products sold to a *water* common carrier that remains on board after the water common carrier reaches its first out-of-state destination

With respect to air common carriers, Revenue and Taxation Code Section 6357.5 provides an exemption for the entire sales price of fuel and petroleum products sold to air common carriers when the fuel and petroleum products are for immediate consumption or shipment in the conduct of the air carrier's business on an international flight. Therefore, if an air common carrier's final destination were France, for example, current law would exempt the entire sale of fuel purchased in California, even if that carrier had stops in Los Angeles and New York before reaching its final destination. On the other hand, if the air carrier's final destination was somewhere in the United States, current law would impose tax on the entire sale of the fuel in California.

In addition to these exemptions, the law (Revenue and Taxation Code Sections 6366 and 6366.1) also contains an exemption for the sale and purchase or lease of aircraft to persons using the aircraft as a common carrier, and component parts of the aircraft as a result of the maintenance, repair, overhaul, or improvement of that aircraft in compliance with Federal Aviation Administration requirements, and any charges made for the labor and services rendered with respect to that maintenance, repair, overhaul, or improvement are exempt from tax.

Proposed Law

This bill would add Section 6357.7 to the Sales and Use Tax Law to provide an exemption from January 1, 2008 until December 31, 2017 from the computation of the amount of tax on those gross receipts in excess of $1.88 per gallon from the sale or purchase of fuel and petroleum products by an air common carrier on a domestic flight. If enacted, only the first $1.88 per gallon would be subject to tax.

This bill defines the term “domestic flight” to mean a flight whose final destination is a point inside of the United States, including its territories.

This bill would also define the term “air common carrier” to mean a common carrier as defined in Section 23046 of the Business and Profession Code.

This bill would provide that the exemption does *not* apply to any tax levied pursuant to Bradley-Burns Uniform Local Sales and Use Tax Law and Transactions and Use Tax Law, unless approved by the local government that would otherwise receive the revenues derived from the taxes imposed under those laws.

As a tax levy, the bill would become effective immediately.

Background

Until July 15, 1991, sales of fuel and petroleum products to air, water, and rail common carriers were exempt from sales tax when used in the conduct of the carriers’ common carrier activities after the first out-of-state destination. The rationale for this exemption was that it made California ports and airports more competitive, and it established consistency in the Sales and Use Tax Law for interstate and foreign commerce sales by exempting that portion of the fuel which was actually transported outside this state prior to any use. However, because of the budget crisis in 1991, this exemption was repealed by AB 2181 (Stats. 1991, Ch. 85) and SB 179 (Stats. 1991, Ch. 88).

In 1992, however, AB 2396 (Ch. 905) restored this exemption for fuel and petroleum products, but only with respect to water common carriers, and only until January 1, 1998. The sponsors of that measure, Pacific Merchant Shipping Association, successfully argued before the Legislature that the July 1991 repeal of the exemption had been directly responsible for a decline in the number of ships which bunker in California ports, and that reinstating the exemption would increase bunker activity in California. The sunset date of January 1, 1998 was extended until January 1, 2003 by AB 366 (Stats. 1997, Ch. 615). Subsequent legislation extended the sunset date to January 1, 2014 (Ch. 712, SB 808, Stats. 2003).

Two bills to restore the exemption for air and rail common carriers were introduced in the 1996 Legislative Session. AB 3375 (Olberg) would have restored the exemption for rail common carriers. AB 566 (Kaloogian) would have restored the exemption for air common carriers. According to a Department of Finance analysis of AB 566, “Governor Wilson has proposed a different form of tax relief for the aircraft industry. Under the

Governor's proposal, a sales tax exemption would be extended to property that becomes a component part of an exempt aircraft as a result of maintenance, repair, overhaul, or improvement of the aircraft in compliance with FAA requirements." The Governor's proposal was actually enacted in the 1996 Legislative Session by SB 38 (Lockyer, et al., Stats. 1996, Ch. 954) which, among other things, included the sales tax exemption for the component parts.

Four bills over the last decade have been introduced that would also have exempted from sales tax that portion of the sale of fuel and petroleum products sold to an air common carrier that is left on board after the air common carrier reaches its first out-of-state destination:

- AB 1800 (Machado, 1998) was held in the Assembly Appropriations Committee.
- AB 2470 (Wiggins, 2000) died in Assembly Revenue and Taxation Committee.
- SB 1510 (Knight, 2002) died in Senate Revenue and Taxation Committee.
- SB 998 (Margett, 2005) died in Senate Revenue and Taxation Committee.

Three other bills, similar to this bill, would have exempted from the sales and use tax, those gross receipts in excess of a specified amount per gallon on the sale or purchase of fuel and petroleum products by an air common carrier on a domestic flight:

- AB 2897 (Wiggins, 2002) would have exempted those gross receipts in excess of $0.50 per gallon on the sale or purchase of fuel and petroleum products by an air common carrier. This bill was held in the Assembly Appropriations Committee.
- AB 236 (Bermudez, 2005) would have exempted those gross receipts in excess of $0.632 per gallon on the sale or purchase of fuel and petroleum products by an air common carrier. This bill died in Assembly Revenue and Taxation Committee.
- SB 1619 (Dutton, 2006) would have exempted those gross receipts in excess of $1.131 per gallon on the sale or purchase of fuel and petroleum products by an air common carrier. This bill died in the Senate Revenue and Taxation Committee.

COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by the author to create an exemption for sales of fuel to air common carriers since the exemption previously afforded to sales of fuel to air common carriers was repealed in 1991 due to budget constraints. The state's high tax rate, coupled with the excessive cost of fuel per gallon, is having a dramatic impact on the airline industry's activities in California.
2. **All air common carriers wouldn't be treated alike.** This bill defines an air common carrier by referencing Section 23046 of the Business and Professions Code. This section defines "air common carrier" to mean "a person engaged in regularly scheduled air transportation between fixed termini under a certificate of public convenience and necessity issued by the Civil Aeronautics Board, or its successor, or the Public Utilities Commission, or its successor, and 'airplane' or 'common carrier airplane' means an airplane operated in air transportation by an air common carrier." This definition is used in terms of the applicability of alcoholic beverage licensing laws to air common carriers selling distilled spirits on board airplanes operating in this State.

The Board, however, has defined “air common carrier” for purposes of the sales and use tax exemptions currently applicable to these persons through its Regulation 1621, *Sales to Common Carriers*. This regulation defines common carriers to include carriers such as those defined in this bill as well as other carriers, such as charter carriers, private carriers, or contract carriers, so long as they are engaged in the business of transporting persons or property for hire or compensation and offer these services indiscriminately to the public or some portion of the public. Is it appropriate to have two different definitions in law for the same term? This could add confusion in the proper reporting of those sales to carriers that remain subject to tax.

3. **The local government option, if exercised, would eliminate the uniform base of local and district taxes.** The bill would allow local governments to opt into the proposed exemption if they vote to do so. If no local governments opted into the proposed exemption, sales of fuel and petroleum products would be exempt at the rate of 6-1/4% (the state rate of 5-1/4%, the 1/2% Local Revenue Fund rate, and the 1/2% Local Public Safety Fund rate). All sales made within jurisdictions imposing a district tax would be subject to only the district tax rate.

   However, if local governments opt into the exemption, California would be left with a variety of differing rates on sales of fuel and petroleum products. Some practical questions would arise as well. For example, if a city doesn’t opt into the exemption for its Bradley-Burns tax (1/2%), but a county does (3/4%), does the entire Bradley-Burns tax then go to the county within the city limits? That is, would the offsetting city credit disappear?

   In addition to the likelihood of increased errors on sales and use tax returns, there would be an added burden placed on the retailers making the sales. The retailers receive no direct economic benefit from the proposed exemption, yet the retailers would be required to 1) program their computers to allow for a separate rate for the fuel sold to air carriers on a domestic flight versus all other fuel and petroleum product sales, 2) obtain and retain necessary documentation to support any exempt sales to qualifying carriers, and 3) account for the exempt sales for purposes of properly reporting their sales and use tax obligations to the Board.

   Also, it is unclear whether “local government” would mean the people of the local jurisdiction voting on the measure or the governing body. Because one provision in the bill states the governing body allowing the exemption shall notify the Board, it would appear that the approval would be by the governing body, and not the local electorate. This should be clarified consistent with the author’s intent.

4. **The proposed definition of “domestic flight” and current law’s definition of “international flight” geographically overlap.** The bill would define “domestic flight” as a flight whose final destination is a point inside the United States, including its territories. Territories of the United States would include all of the following:

   Guam
   Midway Islands
   Navassa Island
   Northern Mariana Islands
   Palmayra Atoll
   Puerto Rico

U.S. Virgin Islands
Wake Island
American Samoa
Baker Island
Federated States of Micronesia
Howland Island
Jarvis Island
Johnston Atoll
Kingman Reef (mostly maritime territory)

As stated earlier, current law (Section 6357.5) provides an exemption for the sale or purchase of fuel and petroleum products sold to air common carriers when the fuel and petroleum products are for immediate consumption or shipment in the conduct of the air carrier's business on an *international* flight. "International flight" is defined to mean a flight whose final destination is a point outside the United States. If enacted, these provisions would conflict, since the above territories are considered outside the United States. So, would fuel purchased by an air common carrier for a flight that has a final destination to Guam be fully exempt as provided by current law, or partially exempt under the provisions of this bill?

NEW MANUFACTURERS AND SOFTWARE PRODUCERS (SECTION 6377)

Current Law

Under current law, entities engaged in activities such as manufacturing, research and development, and software producing activities that make purchases of equipment and other items for use in the conduct of their activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for purchases of equipment used by these entities.

The statewide sales and use tax rate (7.25%) imposed on taxable sales and purchases of tangible personal property is made up of the following components (additional district taxes are levied among various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	R & T Code
5.0%	State (General Fund)	6051, 6201, 6051.3, 6201.3
0.25%	State (Fiscal Recovery Fund)	6051.5, 6201.5
0.50%	Local Revenue Fund	6051.2, 6201.2
0.50%	Local Public Safety Fund	§35 Art XIII St. Constitution
1.00%	Local (0.25% County transportation funds 0.75% City and county operations)	7203.1

Proposed Law

This bill would add Section 6377 to the Sales and Use Tax Law to provide a partial exemption (5.25%) from January 1, 2008 until January 1, 2018 from the statewide sales and use tax rate for the following purchases by a “qualified person”:

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, fuels, pollution control equipment, buildings and foundations), as specified.
- Tangible personal property purchased for use primarily in research and development.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any qualifying equipment.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified person who will use that property as an integral part of the manufacturing process, as described.

The bill would define a “qualified person” as any new trade or business, as specified, that is engaged in manufacturing activities, as described in the Standard Industrial Classification (SIC) Manual Codes 2011 and 3999, and software production activities as described in SIC Codes 7371 to 7373.

The bill would specify that the proposed exemption would *not* include 1) any tangible personal property that is used primarily in administration, general management or marketing, 2) consumables with a normal useful life of less than one year, except for fuels used in the manufacturing process, and 3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

As a tax levy, the bill would become effective immediately upon enactment.

Background

For a ten-year period ending December 31, 2003, the law provided a partial sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and an income tax credit for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal SIC codes. The partial exemption applied to the state tax portion of the statewide rate for sales and purchases of qualifying property, and the in lieu income tax credit was equal to six percent of the amount paid for qualified property placed in service in California. Qualified property essentially was depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. Certain special purpose buildings were included as "qualified property." New manufacturers could receive either the benefit of the exemption, or claim the income tax credit. However, existing manufacturers could only receive the benefit of the income tax credit.

This partial sales and use tax exemption and income tax credit had a conditional sunset date. The sunset was to occur in any year following a year when manufacturing employment (as determined by EDD) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (indeed, it was LESS than the 1994 number by over 10,000), and therefore the MIC and partial sales tax exemption sunsetted at the end of 2003.

The manufacturer’s sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

Since the expiration of these tax incentives, numerous measures have been introduced to either reinstate or to expand or modify the incentives. Listed below are similar measures considered during the 2005/06 Legislative Session:

- AB 2218 (Torrico) - would have, for a 10-year period beginning January 1, 2007, provided a state sales and use tax exemption (5.25 percent) for purchases of qualifying tangible personal property by trades or businesses and their affiliates, as specified and defined. The bill was held in the Assembly Appropriations Committee.
- AB 2395 (Villines) - would have provided, for calendar years beginning on or after January 1, 2006, a state sales and use tax exemption for tangible personal property, as defined, purchased for use by manufacturers that have "gross aggregate gross assets" used in the manufacturing activity not exceeding $5 million. The bill would also have provided a corresponding 6 percent income tax credit on purchases of similar property. The bill was held in the Assembly Revenue and Taxation Committee.
- AB 2595 (Arambula) - would have, among other things, required the Board to grant a "small size manufacturer," as defined, a "sales and use tax offset," as defined, against that manufacturer's tax liability, as specified. The bill was gutted and amended to become a proposed training initiative to increase workers' skills in manufacturing and goods movement and was ultimately vetoed by the Governor.
- SB 1291 (Alquist) - would have provided a state sales and use tax exemption (5.25 percent) for purchases on or after January 1, 2006, of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, software production, and newspaper printing, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment. This measure died in the Senate Revenue and Taxation Committee.
- SB 1643 (Runner) – similar to SB 359, was held in the Senate Revenue and Taxation Committee.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments against and in support of these tax incentives were presented:

Arguments Supporting the MIC

- Investment Incentive—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.
- Relocation Incentive—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.
- Efficient Job Allocator—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.

- Other Arguments. Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- Inequitable Taxation—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.
- Relocation Rather Than Creation—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of "prisoners' dilemma"—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.
- Inefficient Development Policy—Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives "windfall benefits" in the form of reduced taxes.
- Ineffective Development Policy—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or expansion of business compared to the adverse fiscal effects that such measures can have on the state.

COMMENTS

1. **Sponsor and purpose.** This provision is also sponsored by the author. It is intended to stimulate California's manufacturing and software production industry by providing tax incentives to new establishments engaged in these activities.
2. **Technical issues:**
   - In defining "qualified person," it is recommended that the bill require that the qualifying entity be *primarily* engaged in the activities described in the referenced codes. This is an important issue and one that generated a lot of disputes when the Board administered Section 6377 previously. Staff will work with the author's office in drafting amendments as the bill progresses through the Legislature.

- Also, in subparagraph 6, “qualified person” is partly defined as a person wholly engaged in business outside of California that first begins doing business in this state after December 31, 2002 other than by purchase or other acquisition. Yet, in subparagraph 7, the language specifies that notwithstanding paragraph (6), a qualified person shall not include any person who has conducted business activities in a new trade or business for three or more years. These subparagraphs appear to conflict and should be clarified to avoid confusion.
- Another issue relates to the proposed definitions for the types of property included or excluded from the proposed exemption. For example, on page 10, line 34 and page 11, line 8, the bill refers to the items having a useful life of one year or more (or less). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.
- The original exemption was added in 1993 and referenced the SIC codes for purposes of qualifying entities. This bill would also reference those codes on page 9, lines 35-36 and page 10, lines 17-20 . However, the North American Industry Classification System (NAICS) has replaced the SIC codes, and should be used to reference the activities the author intends to describe.
- On page 7, line 30, the bill incorrectly references paragraph (3). The language should read, “(1) or (2).”
- On page 10, line 35, the bill incorrectly references paragraph (11). The correct reference should be paragraph (12).

3. **Related measures.** Other measures that would provide an exemption for manufacturing and other related activities include:
   - AB 1152 (Niello) would, beginning January 1, 2008, provide a state sales and use tax exemption (5.25 percent) for purchases of qualifying tangible personal property by persons engaged in manufacturing and software production, as specified and defined.
   - AB 1206 (Smyth) would provide a state sales and use tax exemption (5.25%) for sales and purchases of machinery and equipment used in research and development activities, as specified.
   - AB 1681 (Houston) would, beginning on the first January following the fiscal year in which the state budget deficit for the 2008-09 fiscal year is eliminated, provide a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified.

MOTION PICTURE CREDIT (6902.5)

Current Law

Under existing law, a sales tax is imposed on retailers for the privilege of selling tangible personal property in this state. The use tax is imposed on the storage, use, or other consumption of tangible personal property purchased in this state. Either the sales tax or the use tax applies with respect to all sales or purchases of tangible personal property, unless that property is specifically exempted.

With regard to the motion picture industry, the Sales and Use Tax Law provides the following:

- Section 6378 of the Sales and Use Tax Law provides an exemption from the 5.25 percent state sales and use tax, for the sale and purchase of any tangible personal property purchased for use *primarily* in teleproduction or other post production services, as described, by a qualified person that is *primarily* engaged in teleproduction or post production activities, as defined in Code 512191 of the North American Industry Classification System Manual, published by the United States Office of Management and Budget, 1997 edition.
- Section 6010.4 provides that when certain persons form partnerships to reduce the cost of producing motion pictures through the sharing of the use of equipment and other assets, the furnishing of that property, without the transfer of title, by the partnership to its members for the purpose of producing motion pictures by its members does not constitute a "sale" or a "purchase" and, therefore, no tax applies to the furnishing of that property.
- Section 6010.6 provides that "sale" and "purchase" do not include the following: 1) any transfer of any qualified motion picture, or any interest or rights therein, when the transfer is prior to the date that the qualified motion picture is exhibited or broadcast to its general audience, and 2) the performance of qualified production services, as defined, in connection with the production of any qualified motion picture, as defined. Therefore, no tax applies to these transactions.
- Sections 6006 and 6010 provide that leases of motion pictures or animated motion pictures, including television, films, and tapes, (except video cassettes, tapes, and discs leased for private use under which the lessee does not obtain the right to license or broadcast) do not constitute "sales" or "purchases." Therefore, no tax applies to these transactions.

Proposed Law

This bill would, among other things, add Section 6902.5 to the Sales and Use Tax Law, Section 17053.85 to the Personal Income Tax Law, and Section 23685 to the Corporation Tax Law, to do, among other things, the following:

1. Allow a credit to a qualified taxpayer against the personal income tax or the corporation tax an amount equal to 12 percent of the qualified amount (plus an additional 3 percent for certain productions), not to exceed $3 million per qualified motion picture.
2. Define "qualified taxpayer" as an applicant who has been allocated tax credits by the California Film Commission (CFC).

3. Require the CFC to determine and designate who is a qualified taxpayer and allocate tax credits up to a maximum of $10 million per quarter to qualified taxpayers, as provided.
4. Require the CFC to provide to the Board at least annually of the specified information on the qualified taxpayers and the total amount of the tax credit allocated to each qualified taxpayer.
5. Until January 1, 2018, allow qualified taxpayers, in lieu of claiming the income tax credit, to either claim a refund of sales or use tax paid under the Sales and Use Tax Law, or claim a credit against liability for sales or use tax due, that is equal to the credit amount that would otherwise be allowed under Sections 17053.85 or 23685.
6. Require the FTB to provide an annual listing to the Board of taxpayers claiming the income tax credit.
7. Require the FTB and the Board to provide an estimate of the increased tax revenues derived from California-produced motion pictures and commercials retained by the state because of this proposed credit.

As a tax levy, the bill would become effective immediately.

Background

Two similar measures were introduced in the 2005-06 Legislative Session: AB 777 (Nunez) which, as amended on August 17, 2005, would have provided a similar 12 percent credit, and SB 58 (Murray and Pavley), which would have provided a 15 percent credit. AB 777, as amended on August 17, 2005 was never heard in committee, and SB 58 died in the Senate Revenue and Taxation Committee.

COMMENTS

1. **Sponsor and purpose.** This provision is sponsored by the author to create incentives in the law to discourage the practice of producing and filming motion pictures and commercials outside California.
2. **This analysis focuses primarily on the provisions contained in proposed Section 6902.5 which would fall under the Board's purview.** Some implementation concerns are noted below:
   - **Shouldn't the Franchise Tax Board (FTB) administer the refunds?** The Board would be required to make refunds or approve credits based an amount that would otherwise be allowed under the income tax laws. It appears more appropriate to retain administration of this credit mechanism within the FTB – especially considering the fact that this is largely a wage-based credit, and there may be a variety of qualified taxpayers that aren't even registered with the Board to offset sales and use taxes paid or due.
   - **The bill should define "sales or use taxes paid."** The bill would allow a qualified taxpayer to claim a refund for sales or use taxes paid. It is unclear what this provision means. Would this include payments of sales tax reimbursement or use tax to other retailers? Does it mean the amount of sales or use tax paid to the Board as far back as when the taxpayer began filing sales and use tax returns? Does the amount include taxes other than the State's General Fund, such as the Fiscal Recovery Fund, and local and district

taxes? It is essential that this be clarified in the bill, in order to determine the impact this measure would have on the Board's workload.

- **The provisions of proposed Section 6902.5 are confusing**. Subdivision (a) would limit the allowable refund to the amount of sales and use tax paid, or as a credit against liability for sales or use tax due. Yet subdivision (c) provides that in the case where the credit allowed by Section 6902.5 exceeds the qualified taxpayer's sales and use tax liability, the excess shall first be credited against other amounts due from the taxpayer to the state, such as liabilities due the Board, FTB, or payments due pursuant to the Unemployment Insurance Code, and *may* be carried over to reduce any amounts due in the succeeding years if necessary until the credit is exhausted. With these provisions, it appears the only time in which a refund would be initiated would be when the qualified taxpayer is no longer an employer or generating income in California. It that the intent of this provision?

- **The impact to the Board appears to be minimal, unless we have to verify sales tax reimbursement or use tax paid to other retailers.** Subdivision (f) would require the CFC to provide a list of the taxpayer names, and other related information, to the Board with the total amount of the tax credit allocated to each qualified taxpayer. Other than simply doing the necessary paperwork to generate the refund or apply the credit, it appears the Board would have a minimal role in this credit proposal. However, the term "sales or use taxes paid" should be clearly defined in order for the Board to determine the actual impact this provision could have.

- **The Board should be authorized to share information with the CFC.** When the Board makes a refund, or applies a credit to a sales or use tax liability, it appears it would be essential that the CFC be made aware so that it could ensure that the total allowable credits do not exceed the allowable cap of $10 million per quarter. However, the bill doesn't authorize the Board to do so. Section 7056 of the Sales and Use Tax Law prohibits the Board from releasing tax information about taxpayers to outside persons or agencies, unless the Governor authorizes such a release. Either Section 7056 would require an amendment, or a special order from the Governor would be required.

- **Subdivisions (e) and (f) are confusing**. In subdivision (e), the bill specifies that interest shall not apply to any return claiming a credit. However, is it the author's intent to allow interest on any refunds claimed? What about a return that is filed that has a credit due – would interest apply to that credit amount?

  In subdivision (f), the bill specifies that the CFC shall provide a list to Board of specified information for each partner or shareholder, as applicable. It is unclear what the Board's interest might be in information about partners and shareholders. In case partners held seller's permits separately from the "qualified motion picture" company, we would not anticipate making refunds to anyone other than the qualified motion picture company.

- **Board does not capture data that would accurately reflect increased tax revenues.** The bill would require the FTB and the Board to provide an estimate of the amount of increased tax revenues derived from California-produced motion pictures and commercials retained by the state because of the film production tax credit. It is unclear exactly what this estimate would include and how the Board would make such an estimate. As just one example, would the tax attributable to a caterer's sale of meals served to the productions crew during filming be counted as "increased tax revenues?" If so, capturing any data from sales and use tax returns would be futile, since sales aren't segregated in that detail. In the caterer example, all sales made within a quarter would be reported on the return – whether the catered event is a motion picture-related event or some completely unrelated event. Other increased tax revenues could include, for example, the sales and excise taxes associated with a purchase of cigarettes by a member of the production crew or gasoline in a production crew's personal vehicle, or sales tax on soda, meals, over-the-counter medicines, and sundry items purchased by members of the production crew while on location in California. One could argue that any tax paid on an item purchased by a member of the production crew at any time during production could be regarded as "increased tax revenue" if that member would have otherwise been relocated outside this state for that same production.

COST ESTIMATE

With respect to the proposed air common carrier exemption and the new manufacturer's exemption, administrative costs would be incurred in notifying affected taxpayers, modifying tax returns, revising regulations and pamphlets, and answering inquiries from industry and the public. In addition, because of the potential for a partial tax exemption, with some local governments opting in on the exemption, administrative costs would also be incurred in computer programming, return analysis, and return processing.

With respect to the motion picture provisions, it is unclear how many taxpayers would actually be approved by the CFC for the proposed tax credit, since the bill would require CFC to process and approve (or reject) all applications on a first-come first served basis. This could mean that, the first few applicants could absorb the entire allowable credit, leaving no additional tax credits for any other taxpayers, and the Board would only be processing a few credits.

On the other hand, the bill needs more specificity with regard to defining "sales or use taxes paid" and the Board's role in this credit proposal. If the intent of the bill is to allow a refund or credit up to the amount of sales tax reimbursement or use tax paid by the qualified taxpayers to other retailers, administrative costs would be incurred by the Board to make those verifications. However, the extent of these costs is unknown due to the uncertainty on how many qualified taxpayers would be allocated tax credits for which the Board would be required to audit.

If the intent of the bill is to simply authorize the Board to apply credits based on CFC's allocations, the administrative costs would be minimal. "Minimal" costs is based on the assumption that the CFC would make the notification to qualified taxpayers of the allowable credits and make the necessary verifications that the taxpayers have actually incurred the costs upon which the credit is based. With these uncertainties, it is premature to estimate the administrative costs to the Board.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Jet Fuel

According to the U.S. Energy Information Administration, total sales of jet fuel in California for the year 2005 were 3.8 billion gallons. Approximately 10%, or 380 million gallons, of jet fuel sold in California is for military use. Therefore in 2005, 3.4 billion gallons (3.8 billion gallons – 0.38 billion gallons = 3.42 billion gallons) of jet fuel was used by commercial air carriers. According to the Bureau of Transportation Statistics, total gallonage consumed in the U.S. in 2005 was 19.3 billion. The fuel consumed by international flights accounts for 5.5 billion gallons, which comprises 28 percent (5.5 billion gallons / 19.3 billion gallons) of jet fuel consumed.

Currently, expenditures on fuel for international flights are exempt from sales and use tax. Assuming that jet fuel usage in California is consistent with the national average, the fuel used for domestic flights is 2.4 billion gallons (3.4 billion gallons x 72 percent = 2.4 billion gallons). As of March 2, 2007, the spot price of jet fuel in Los Angeles was $1.9035 per gallon. This bill would exempt that portion of the price over $1.88 per gallon, or $0.0235 per gallon. Therefore, the total annual expenditures that qualify under this provision of the bill are estimated to be $56.4 million (2.4 billion gallons x $0.0235 per gallon = $56.4 million).

Manufacturing Equipment

As stated earlier, the SIC classification system is no longer in use. The NAICS has replaced the SIC system. There is no direct conversion for all industry classification from SIC to NAICS. However, the Economic Census provides a bridge between the old and new classification system as follows:

SIC 2011 to 3999	NAICS 31 to 33 (manufacturing)
SIC 7371	NAICS 541511 (custom computer programming services)
SIC 7372	NAICS 5112 (software publishers) & NAICS 334611 (reproducing)
SIC 7373	NAICS 541512 (computer systems design services)
SIC 4812 to 4899	NAICS 5171 to 5179 (telecommunications)

For the purpose of the estimate, we will use the bridge to the NAICS classification that provides the nearest match the old SIC numbering system. The Annual Survey of Manufacturers, Geographic Area Statistics 2005, Table 3, a US Census Bureau publication, provided that for NAICS 31-33 for California, machinery and equipment expenditures were $11.2 billion. The bill also includes tangible personal property purchased in the performance of a construction contract for a qualified person who will use the tangible personal property as an integral part of the manufacturing process. Construction of building other structures was about $2 billion. We estimate that about half of the expenditures would amount to labor charges for installation that are currently exempt from the tax. This would result in a total of $12.2 billion in NAICS 31-33 capital manufacturing expenditures for machinery and equipment. The bill would include fuel used or consumed in the manufacturing process. The survey reported $3.2 billion for purchases of fuels.

The Annual Capital Expenditures 2005, Table 4a, a US Census Bureau publication, provided U.S. expenditure data for the other codes. For NAICS 5112, U.S. equipment expenditures were $2.5 billion. Based on California's population, we estimate California expenditures to be $300 million ($2.5 billion x 12% = $300 million).

The Annual Capital Expenditures 2005 does not provide a breakout expenditures for codes 541511 and 541512, but they are included in 5415, (computer systems design and related services). For NAICS code 5415, in 2005, U.S. equipment expenditure were $5.8 billion. Based on California's population, we estimate that California's expenditures amount to $696 million ($5.8 x 12% = $696 million). From the information we gathered from the 2002 Economic Census, we estimate that NAICS 541511 and NAICS 541512 represented 42% and 48% of NAICS 5415, respectively. Using the two ratios, we estimate equipment expenditures of $292 million for custom computer programming services and $334 million for computer system design services (NAICS 541511: $696 million x 42% = $292 million and NAICS 541512: $696 million x 48% = $334 million).

The Annual Capital Expenditures 2005, Table 4a, does not have a total expenditure figure for telecommunications. Instead, it provides the following breakdown:

Wired telecommunications carriers (NAICS 5171)	$19.2 billion
Wireless telecommunications carriers (NAICS 5172)	$10.9 billion
Telecommunications resellers, satellite, and other telecommunications (NAICS 5173, 5174 and 5179)	$ 3.2 billion
Total	$33.3 billion

We estimate that California's annual expenditures amount to $4.0 billion ($33.3 billion x 12% = $4.0 billion).

California Expenditures – Summary

Classification		Expenditures (in billions)	
NAICS 31-33	Machinery & Equipment	$	11.2
	Construction contracts	$	1.0
	Fuel consumption	$	3.2
NAICS 51121	Software publishers	$	0.3
NAICS 541511	Custom computer programming services	$	0.3
NAICS 541512	Computer system design services	$	0.3
NAICS 5171 - 5179	Telecommunications	$	4.0
Total Expenditures		$	20.3

The measure states that the exemption would apply to new businesses only. Based on experience with the prior manufacturing equipment exemption, we estimate that the qualifying expenditures would amount to 0.9%. This would result in expenditures of about $180 million ($20.3 billion x 0.9% = $180 million).

Motion Pictures

The bill would place a cap on the maximum amount of allowable income tax credits, at $10 million per quarter. Therefore, the total annual revenue loss associated with this provision would amount to a maximum of $40 million annually.

Revenue Summary

The annual revenue loss from exempting $56.4 million in jet fuel sales in California and from exempting $180 million in manufacturing equipment expenditures is as follows:

Revenue Loss (in millions)

	Jet Fuel	Manufacturing	Total
State (5.00%)	$ 2.8	$ 9.0	$ 11.8
Fiscal Recovery Fund (0.25%)	0.1	0.5	0.6
Local Revenue Fund (0.5%)	0.3	N/A	0.3
Public Safety Fund (0.5%)	0.3	N/A	0.3
Total	**$ 3.5**	**$ 9.5**	**$ 13.0**

In addition, the total annual revenue loss associated with the motion picture provision would amount to a maximum of $40 million annually. The bill does not specify from what revenue source this amount would be deducted.

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